RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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January 30, 1980 **LETTER 775**

Jan. 18, DJIA 867.15; PTI 1176; A-D Ratio –17.18
Jan. 25, DJIA 876.11; PTI 1184; A-D Ratio –17.02

WHAT TO DO: Last week saw bonds reeling lower in one of the worst cave-ins I have ever witnessed in the bond market. This is part of what gold "saw" when it rose into the 700's and 800's. Very simply, gold saw the ongoing destruction of billions of dollars of US capital (and savings) in the form of collapsing bond prices. You must understand that these bonds form the core, and in many cases the major portion, of institutional funds, pension funds and individual savings in this country. Last week, to put it bluntly, was a wipe-out in bonds.

I've been writing for month after month about the serious implications of compounding the debt—as the US is doing. In Letter 770 I outlined the sad state of the US military capability. A few weeks later the Afghanistan crisis hit, and the plight of the US was clear for all to see. Now the US military budget is about to surge higher (probably by $30 billion this year), and the bond market is aghast. On top of high inflationary numbers, whopping new financing and rocketing deficits will be seen in 1980 and '81.

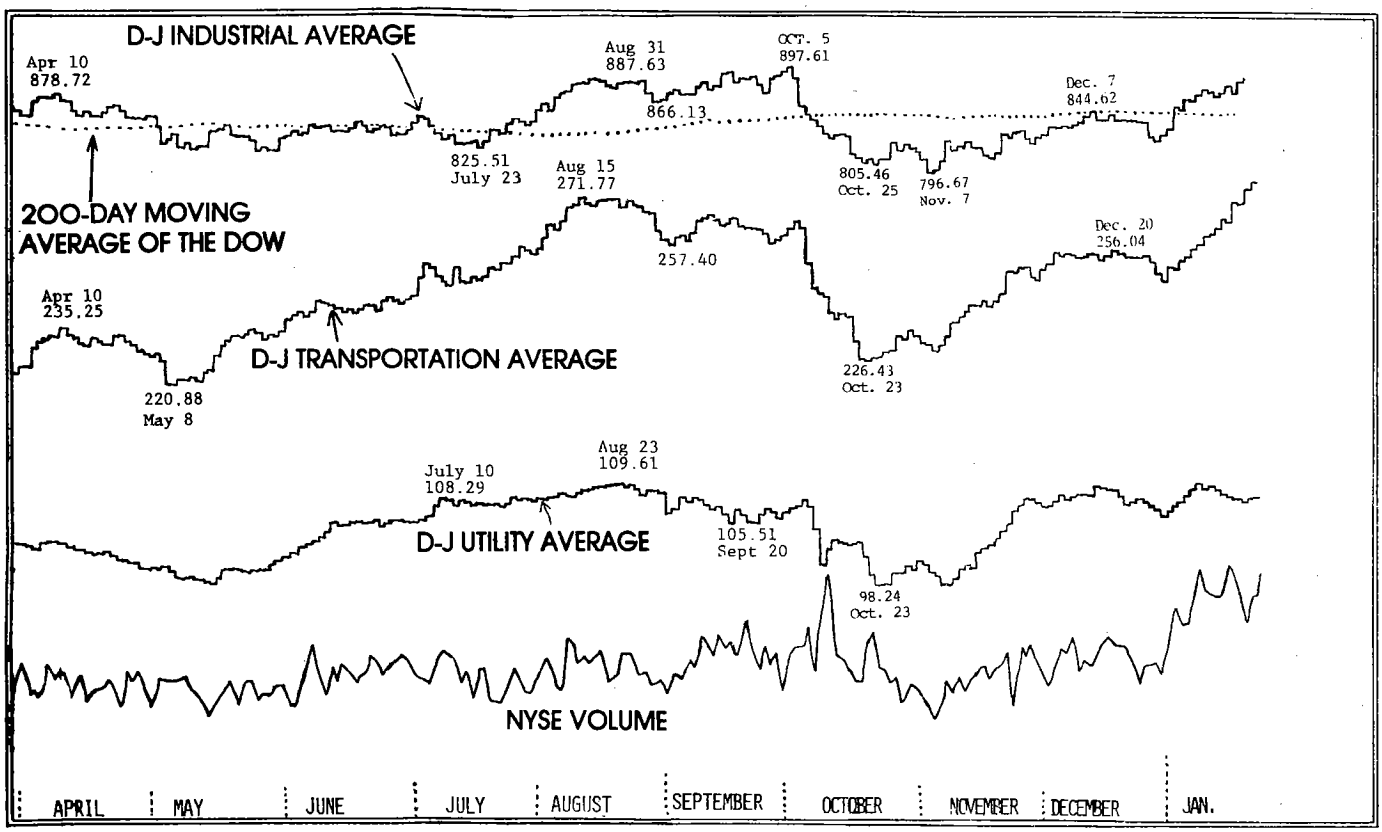
Maybe I'm getting too old for this business. Maybe I'm incapable of understanding the "new inflation mathematics." But I grew up believing that a tumbling bond market represents the worst kind of background for stock prices. Despite the swoon in bonds, however, stocks have pushed higher.

On January 24 my Primary Trend Index (PTI) hit a new record high. My quandary: should I follow the PTI to the exclusion of everything else? I've anguished over this question, and my conclusion is that despite my PTI, despite the new recovery highs in the Averages, I cannot ignore the collapse in bonds.

What has happened, I think, is that many institutional portfolios have been caught with far, far too many bonds and they have been in a frenzy to change the mix—out of bonds and into common stocks. Common stocks are bought because they are "cheap" and because it is hoped that they represent "a store of value" (like gold) in these inflationary times.

My conclusion is this: if the bond market was strong I would now be an all-out bull on stocks, based on many of my technical indicators. But the bond market isn't strong and it isn't just weak—it's in shambles. In all honesty I get a sinking (really sickening) feeling as I watch the bonds plunge. I've recommended a position of about 10% to 15% in gold coins with the rest in short-term Treasury bills. In recent Letters I've changed this mix to the extent of suggesting that some of the bill money be placed in carefully selected stocks. This is as far as I want to go—it's as adventurous as I want to be.

Frankly, I've been amazed that the PTI has been hitting new highs. I've been amazed that the stock market has held up (so far) in the face of the slaughter of the debt markets. Now, if the stock market turns down or if the D-J Industrials fail to push above 897.61, I personally would be very tempted to "take the money and run." By that I mean that I'm nervous about the stock market, I'm very bothered about the bond market, and I'm ready to cash in my stock chips on rather short notice.



THE PICTURE: The fascinating (and rather frightening) thing about markets is that they don't lie. A small group of market analysts, men such as George Schaefer, Jim Dines, myself, Hamilton Bolton, C. V. Myers, Jim Blanchard, Harry Schultz, and a few others started many years ago talking about the way the US was heading and the absolute need to return to the **discipline of gold.** We repeated ad nauseum that you can't get "something for nothing," that "two and two equals four," that "there are no free lunches," that "US politicians are shameless spendthrifts," that the politicians are "lying to the public," and on and on. Our solution was to return to gold, to force US politicians to buckle under to the market discipline of gold. Our prescription to investors: "If the US doesn't return to gold, you buy gold. If the politicians don't give up, the dollar will give out."

People weren't interested. Newspapers and magazines weren't interested. Politicians weren't interested. Two years ago I stood up before 2000 people (at a San Francisco seminar) and argued with former Treasury Secretary William Simon about the need to remonetize gold, to get it back into the system. Simon didn't see it. The dollar, he said, could be handled by Washington. I threw up my hands.

But the markets don't give a damn about my arguments or Washington's promises or Treasury Secretaries' fairy tales or Presidential scoldings or 40 years of good intentions. The markets cut through lies the way a knife cuts through butter. And now that gold has rocketed up, the whole world sees the real story unfolding. And a sad story it is.

Look at it this way. If the US was as powerful as it should be, if the dollar was as strong as it should be, who the hell would be trading in dollars for gold! Even the gold-hating, liberal London Economist said it last week. "The US Turns Soft," was the headline for one of their lead-off articles. So now that we're spent up, pooped out, wined, dined, and inflated, we're called on to spend one trillion dollars over the next five years for defense—to try to catch up with the Russians. Is it any wonder the Arab sheiks are getting heart palpitations and turning in their dollars for gold?

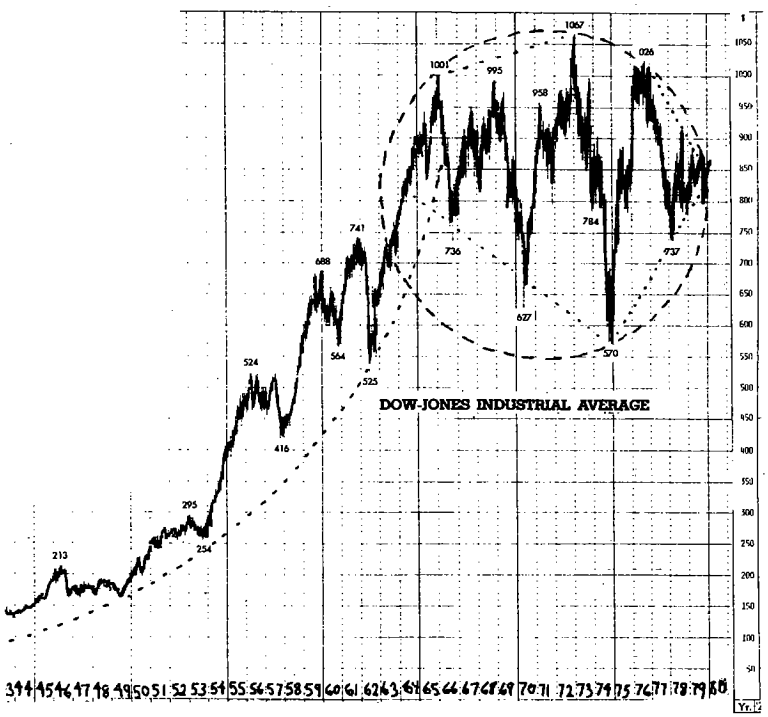
Of course it's true that the sheiks have a problem. Their problem is that they may have to "run for it." And you can't put a barrel of oil in a Swiss bank vault. So the sheiks buy what they can put in the vaults and gold goes up. Meanwhile, Russia makes its moves with relative impunity. Why not? What has she got to worry about? The worst she faces is a terrible scolding from Mr. Carter with the threat of a cut-down in grain shipments and maybe a cancellation of the Olympic games.

What does it all mean for us as investors, as US citizens? First, the rise in gold is telling us that our paper is not as good as gold. It is telling us that our paper is losing purchasing power. And it is telling us that like it or not, we are going to be consuming a lot less over coming years. Why, why is this? It's because we've already spent it all. When you borrow and spend what you haven't got over a period of 35 years, then the ***difference has to come from somewhere.*** That somewhere is the dollar, and that means that the dollar is going to buy less.

The bottom line, then is a CHANGED STANDARD OF LIVING coming up for Americans. The gold move is telling us that. The Russian power is telling us that. The need for a new US defense build-up here is telling us that.

The public senses all this. In the face of a collapse in dollar purchasing power, the public has been borrowing more to keep up their standard of living. They have turned to gambling in the misguided hope of keeping up their standard of living. They have bought gold coins to keep up, and next I believe they could turn to the stock market in an attempt to retain their standard of living. That last possibility will be the subject of this Letter.

WHAT I'M THINKING, WHAT I'M WATCHING: Veteran subscribers know that for a number of years I have been publishing my "great circle" chart, a chart that shows the Dow moving up in an accelerating rising curve from 1932 to the early



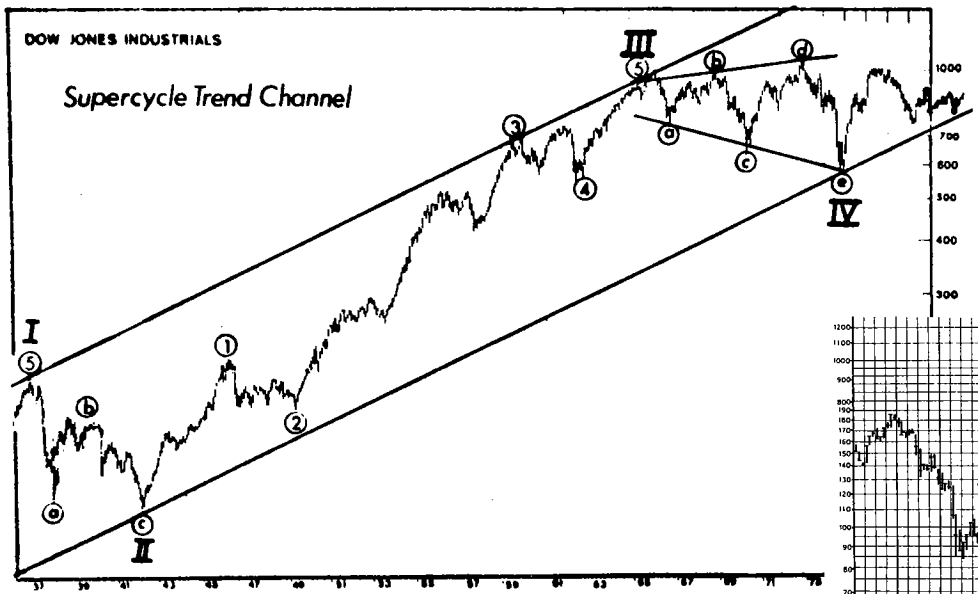
1960's. From around 1963 to the present the Dow has whipped about within this huge circle pattern.

All during last year I warned subscribers that by early 1980 the die would be cast—the Dow would have pushed out of the great circle pattern. The direction the Dow would take on this breakout would be critical, I added. Well, here we are in early 1980, and the circle has been left behind. The DIRECTION of the next major move from the circle-breakout could constitute the most important market "signal" since the 1960's. I am including my chart of the Dow and the great circle, up-dated to include the most recent action.

Another long-term study that I am watching intently now is the Elliott Wave Principle. My friend, Bob Prechter, is one of the true experts in this area (along with A. J. Frost), and I have borrowed the page 3 chart from Bob's most recent report (Elliott Wave Theorist, PO Box 262, Chappaqua, NY 10514). The chart traces the Dow from the end of 1936 to the present. The four major waves are identified, and if this interpretation is correct, we should now be moving into final Wave 5.

One item worth noting is that despite a year of almost unending calamities, the Dow during 1979 never violated the lower trendline of the channel. Bob also notes that the Dow is now at the bottom of the channel which means that it is priced at bear market bottom value as was the case in 1932, 1942, 1949 and 1974.

The top of this channel is roughly in the 2860 area for the Dow. And that is where Prechter expects the Dow to go during the 5th



wave of the great bull market that began in 1932 (the 5th Wave is usually the most speculative wave and is accompanied by the highest volume). Prechter expects the 5th Wave to end around 1984.

Here's a principle worth noting. During a labored advance, watch the weakest component or average. When the weakest component turns strong, the advance will gather momentum. The converse is true during a labored decline.

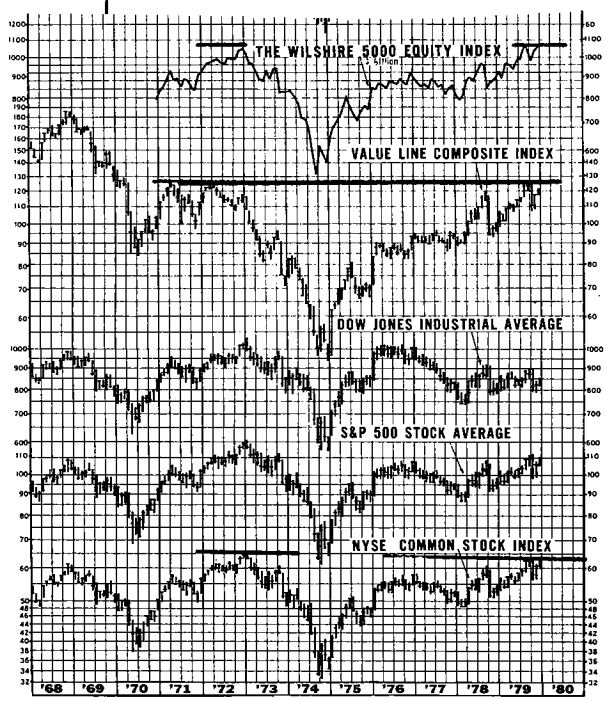
By all odds, the weakest component of the market since 1976 has been the Dow. For that reason, I believe that full attention should be given to the Dow at this time. Here are some of the items I am watching.

First, the 1976 high for the Dow was 1014.79. The lowest closing since 1976 was the February, 1978 low of 742.12. The halfway (50%) level between the 1976 high and the 1978 low is 878.45. If the Dow can climb and hold above 878.45 I would consider that a positive performance. It would then suggest an ultimate attack on the 1979 high of 897.61. Bettering 897.61, I would expect an attack on the 1978 high of 907.74, and bettering that I would expect an attack on the 1976 peak of 1014.79.

Remember (see last Letter), the Dow has etched out a series of ***4 declining peaks since 1976***. A bettering of last year's peak of 897.61 would reverse that series, and I would take this as a very bullish reversal of the 4-year pattern of declining Dow tops.

Still another area that I am watching is the advance-decline ratio as shown on the long range chart in Letter 773. The A-D Ratio (which is a proxy for ALL listed NYSE stocks) has been in a trading range ever since 1976. The A-D is currently about 2 points below the upper limit of this trading range. My feeling is that IF the A-D can break out above the peak of this trading range, we could see a broad upward move, probably the broadest and most profitable since 1974-76.

A phenomenon which I have not seen anyone discuss is illustrated on this chart which includes five broad market averages and indices. On three of these indices, the picture is particularly interesting. Note on the Wilshire, the Value Line and the NYSE Index that all the stock action since 1971 (!) has taken the form of a huge "head-and-shoulders" bottom. On these indices it's as if all the stock movement of the past 8 years has taken the form of a massive accumulation pattern. If so, we could see a major rise out of this area during 1980. I suggest that subscribers keep this chart and up-date it on your own (all vertical bars are monthly high-low ranges).



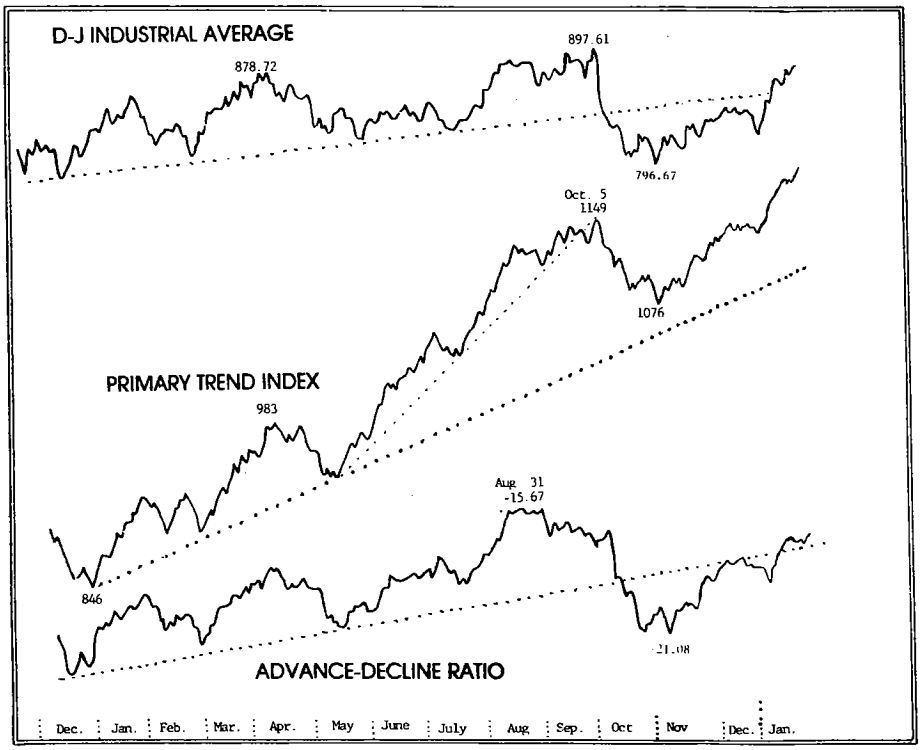
NEAR-TERM: On January 11 my rate-of-change ratio for the Dow turned positive for the first time since last September (the rate-of-change index that I use is the Dow divided by its price of 13 weeks ago). On January 11 the rate-of-change or momentum index jumped to 102. It is now 105.

On January 18 my moving averages studies gave a Dow bull signal when the 13-week moving average crossed above the 50-week MA. I consider this crossing a significant event, particularly since it occurred in the face of an unabated torrent of bad news on the economic and political front.

From the standpoint of the averages and Dow's theory, the news last week (although nobody noticed it) was the advance by the D-J Transportation Average above its 1979 high. This move takes the Transports to the highest point since the 275.71 peak of 1975. The all-time for Transports was recorded in 1969 at 279.88.

The new Transport high means that a state of non-confirmation now exists between the Dow and the Transports.If the Dow is to confirm, it's one thing at a time and the first point is the 897.61 peak of last year.

In the last Letter I gave a dissertation on my Primary Trend Index (PTI), explaining why I thought it was a valuable indicator and why I am giving it more and more credence. The chart on page 4 is self-explanatory. On January 8 the PTI burst above its October 5 peak of 1149 and it has been pushing to new record highs ever since. The PTI is telling us that the technical structure of the market is building rather than deteriorating, and that's bullish.



The advance-decline ratio (bottom of chart) is bothersome in that it is a laggard. But on January 24 the A-D pushed up to record its highest level since November, so at least the A-D is continuing to head in the right direction. It would be a great boon to the market, however, if the A-D could rally above its August 31 figure of minus 15.67.

Conclusion: The market is "over-bought" but I believe this is a rush to buy stocks as a "store of value." As such, the stock market buying could assume (if it has not already) the appearance of a buying panic. If so, the market will brush all normal over-bought indices aside and continue up until exhausted. And as Robert Rhea once said, there is no way to measure "how hot is hot."

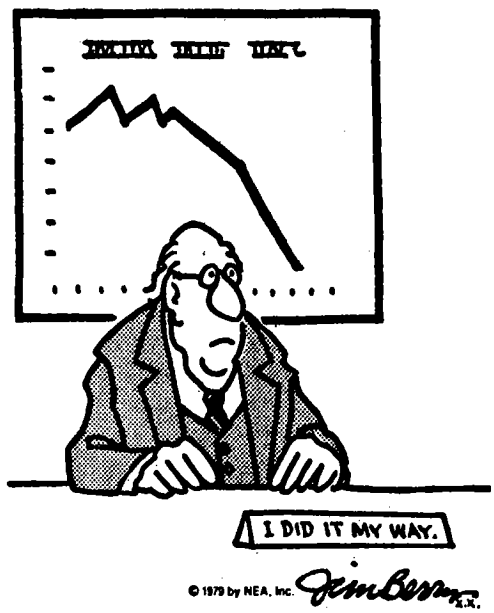
NOTES & QUOTES: The non-Communist world holds about 1.2 billion ounces of gold, with the US holding the biggest hoard (266 million ounces). The reserves of every central bank are made up of gold plus foreign currencies. Since 1976 when gold was $100, the price of gold has risen 6-fold. Thus, the reserves of the gold holding nations have also risen tremendously. Since nations can issue more currency as their reserves rise, the gold boom has enormously increased the currency-printing potential of the world. Should gold hold anywhere near its current price, we could have a new major inflation. And the two places where inflation has not really hit yet are (1) stocks, and (2) commodities. It may not happen—but it's a thought.

* *

Many people wonder why Europe is not jumping to aid the US in its belated, "born-again" struggle against Russian aggression. Others wonder why Europe has not immediately boycotted the "Russian Olympics." If you wonder, then mull over these items: West Europe received 7% of its natural gas in '79 from Russia (Austria received 50%). Russia supplies 35% of all enriched uranium to Europe. About 40% of European coal imports come from Russia and Poland. About 5% of European oil comes from Russia (Italy gets 10% of its oil from Russia). At least 60% of the hard currency debt owed by Russia to Western banks is owed to European banks. Are you beginning to get the idea?

* *

I thought this cartoon was appropriate here. It should help all frustrated subscribers. Here we see old Purvis looking downright disgusted. He missed the gold move, he was short the defense stocks, he was leveraged in long-term bonds, he sold 10 bags of silver in mid-1978 and he's been a raging bull on Sears. But at least he had the satisfaction of telling people, "I did it my way!" RIP.



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From our "Bet you didn't know" department. Art Rooney purchased the Pittsburgh Steelers during the depths of the Great Depression for $12,000. But he waited 41 years for his team to win a championship. How's that for patience in investing! Actually, this illustrates an important point. Many of the largest fortunes have been made through investments in what the investors loved and therefore never sold. Examples: Rooney in football, Norton Simon in art, many very valuable stamp and coin collections, etc.

* *

My friend Morgan Maxfield ran me ragged around the New Orleans Superdome one morning last year. Morgan is not only a good jogger, he is a good thinker. I thought the following was well worth repeating (Economic Meteorology, 1900 Erie St., N. Kansas City, MO 64116).

A word on the Carter embargos. It is a major mistake for Carter, for the farmer, and for America. First of all, you cannot embargo grain to the Soviet Union and expect the Soviets not to buy it from Poland and other trading partners. The Soviets will buy all the grain they wish at cheaper prices because of the embargo.

Secondly, the real negative impact is the psychological disappointment to the farmer. Candidates Carter and Ford pledged in 1976 that there would be no new grain embargos, that in this world market they were ineffective, and that embargos only hurt America's ability to market her grain. The 1973 embargo by Nixon on soybeans precipitated the development of our biggest soybean competition — Brazil — because Japan said this would never happen to her again.

Lastly, there is no way to compensate the farmer for his losses. Oh, the government is purchasing the export firms' contracts totaling $2.25 Billion. But what about the millions of bushels of grain that is stored on farms in the hopes that the Soviets will buy more grain. The farmers are left holding the bag, just when we need every dime of foreign farm sales to offset our high level of energy and auto imports.

Reading about Chrysler, the Soviet Grain Embargo and oil imports reminds me of Walter Heller's axiom on government: "If you want to muff a job, turn it over to government. Government has demonstrated that it can do nothing well — not even collect taxes. That is why they have business collect most of their taxes." But the irony is that government, with the right strategy, could be a great servant of the people.

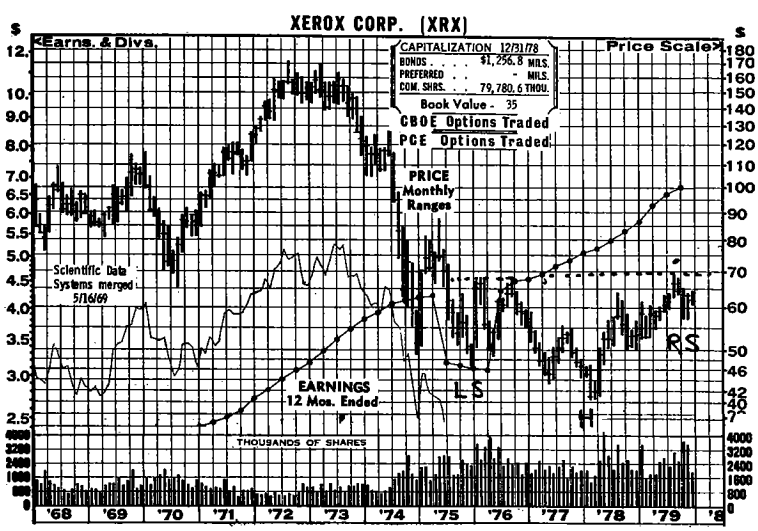
* *

From our "It could only happen in California" department, last week thieves stole the San Diego Police Chief's car. The car was later recovered in Mexico. Thieves here have dropped even the facade of decency!

* *

California has had a big earthquake roughly every 70 years, and the last monster quake occurred in 1906. At that time San Francisco took the brunt of it, but actually fire not quake wiped out much of SF.

Well, it's around the 70-year time again, and the Coast should be in for a major bone-jarrer again. Last week San Francisco had a 5.3 (Richter Scale) quake which shook up a lot of people and cost a few million, but it was nothing like 1906. I hope last week's quake served as the "70-year Special," but I'm not at all sure it did. The nearest major ground fault to San Diego is about 120 miles away, and this city has never been guest to a major earthquake. My friend, Joe Granville, has become very expert at predicting earthquakes and he thinks a whopper is going to hit the West Coast within a year. He expects that at the time California real estate prices will slide towards the basement and all hell will break lose. Joe, tell me that last week's SF quake was all we're going to see! I've got enough to worry about without sweating out something like a 7.5 scale horror. No wonder Joe lives in Florida!



STOCKS: Most of the defense stocks recommended here over recent months have provided gains. Some have provided big gains, and I hope the stocks are not overdoing it now.

One stock that I have been watching for many months is Xerox, and as you can see by this Security Research chart, XRX has now formed a huge head-and-shoulders bottom. I'm not saying buy it today, but if the Dow can continue to ignore the dying bond market and break over 897.61, I would think Xerox would be a candidate for a major move to the upside. At any rate, I'm always a sucker for a beautiful chart and this is one.

GOLD: Current huge margins now required in the gold commodity market have practically ended gold as a commodity "play" (at least for the present). At the coin sector, dealer spreads of up to $50 per coin are now common, and this means that speculation in gold coins has practically ended. At this stage of the game, it's a case of "buy and you're locked in, sell and you're locked out." In the face of this kind of treatment (brought on as a result of the wild fluctuations), much of the steam has gone out of the gold (and silver) boiler.

My point and figure chart (each box equals 8 points) shows the first severe break in gold since the 368-430 area. The chart also shows me support at the 580-630 level. A major rising trendline offers major support at just over 500. The last gold rise ran from 368 to 850 without a correction. A 50% correction would take gold back to 580. Breaking 580 would suggest that gold could test the rising trendline at 500-525.

The exponential moving averages (MA's) of gold (NOT shown in this letter) gave a preliminary bearish signal last week as spot gold dropped to 630 in New York, thereby breaking decisively below the 5-week MA which now stands at 669. The 13-week MA is at 553 and the 50-week MA is at 384. A more important "sell" signal would be given if the 5-week MA drops below the 13-week MA. This has not occurred.

Analysis of a wildly swinging, emotional market such as the current gold market is no easy task. I've been watching gold for 20 years, and the 1979-80 action was enough to make me dizzy. Please turn to my semi-log monthly chart (page 6). In the last Letter I commented that gold had "blown out" above the top of its rising channel, and therefore I concluded that gold was "vulnerable." Events since then proved that it was.

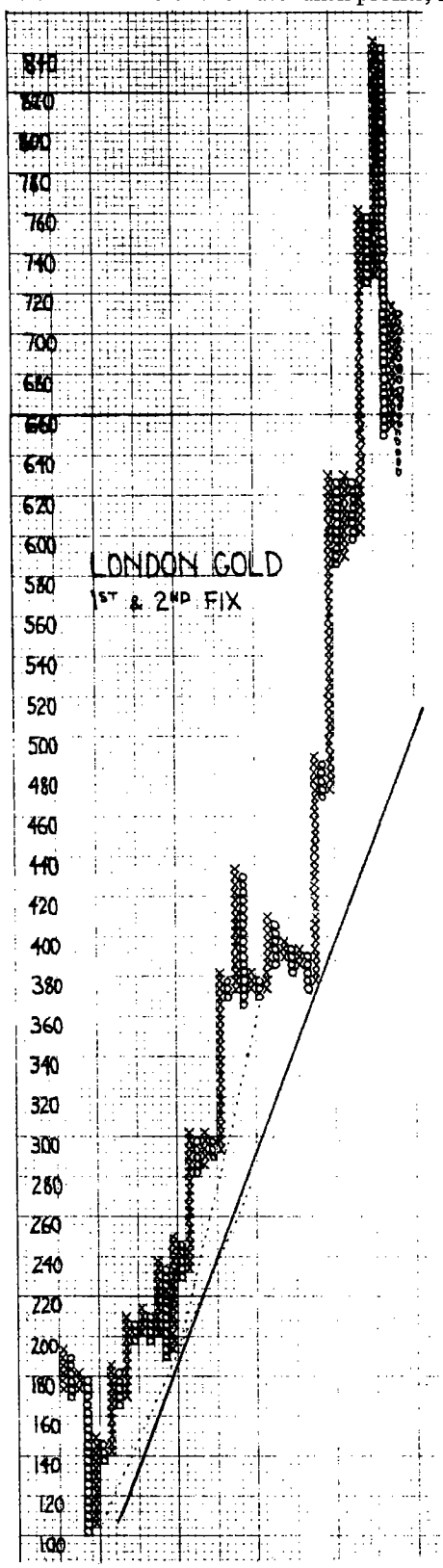
Here's what I think happened. I believe that the second phase of the bull market in gold probably would have ended near the upper channel on this chart at around 500. Then Iran hit the headlines and then Afghanistan. The twin events brought in heavy "unexpected panic buying" (much of it from the Mideast) and gold exploded.

Unfortunately, upward blow-offs can give way to downside blow-offs. Since the last Letter gold has lost 25% of its peak value. My thought, as I study this chart, is that much distribution has occurred over 700 and gold has completed the *second phase*. The second phase ended at point III on the chart (which was 875 on the January spot commodity contract and 850 on the actual London fixing). It would therefore be entirely normal to see gold correct back within its rising channel, and this would entail a retreat to or below the 525 area. A retreat back to the **middle** of the channel would entail a drop back to about the 350 level.

If the second phase of the gold bull market is indeed over, then a severe correction would not be unusual. For it is following a bull market's second phase that the severest and most deceptive declines occur. This is necessary since the post-second phase reaction serves to put the item *back into strong hands again*. And this is necessary as a preliminary for the take-off into the third and final phase.

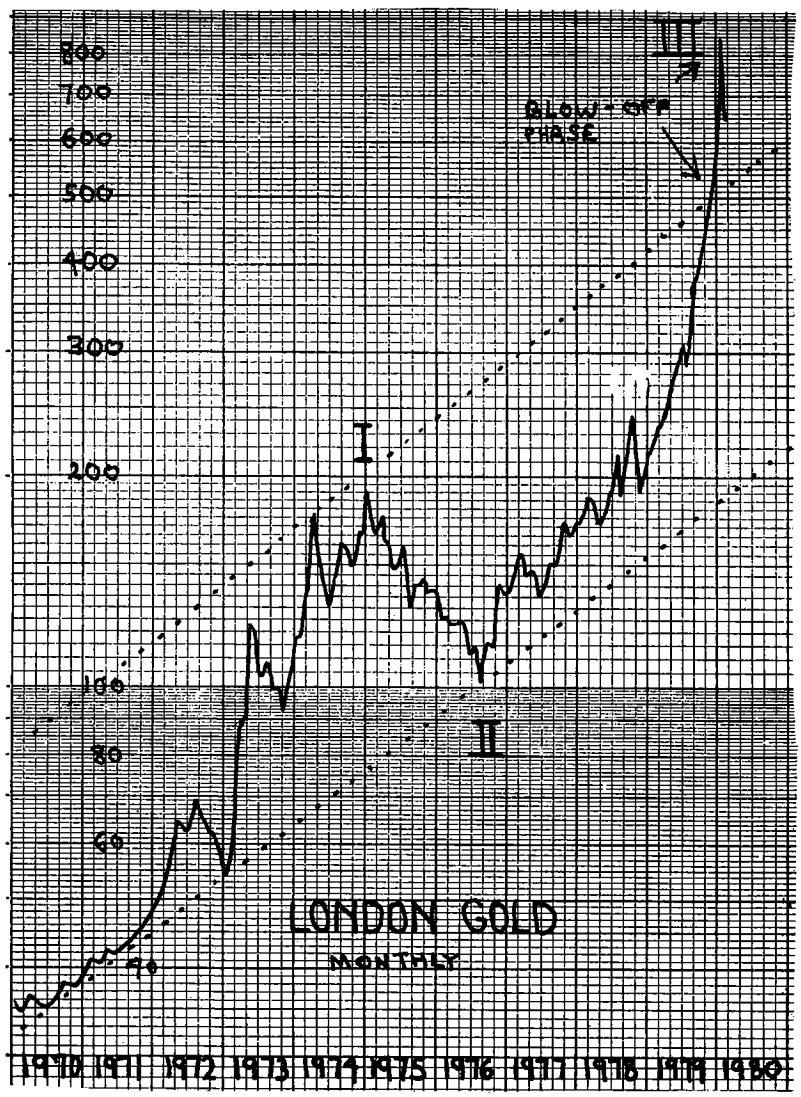
Of course, what I write here is theory, not fact, but it is how I think the gold bull situation could develop. Following a second phase reaction (which should be shorter in time than the correction from points I to II, the third and final phase of the gold bull market will develop. This final phase (Wave V) could take gold into the wild blue yonder, perhaps double or even triple its phase III peak.

Thus, it will pay us to watch carefully from here on, during this gold correction. For those who have taken profits, for those who have not bought all the gold they want, for those who own no gold, the next buying opportunity could lie somewhere ahead. Subscribers who own the prescribed 10% to 15% of assets in gold should sit tight with the intention of adding more and increasing their percentage position in the months ahead. If I am correct, if the third phase of the gold bull market lies somewhere ahead, then the final bull advance in gold should be quite something to see. It will be even more spectacular to be IN.



LATE NOTES: The current market finds me split in my feelings. The PTI is impressive; new highs in the PTI are always impressive. But the glaring non-confirmation in the Averages bothers me. Glancing at the page 1 chart you can see that the Industrials have so far *failed* to better last year's high, a feat which the Transports accomplished last week.

Until Industrials better 897.61 I will be nervous about this market. The ongoing collapse in the bond market only heightens my nervousness. No, I did not forget to include new individual stock purchases in this Letter. I don't want to recommend anything more until the non-confirmation in the Averages clarifies itself one way or the other. Remember what I have said over and over during the past few years, "In an inflation where the basic currency of a nation is rotting away, it's the man who loses least who ends up the winner." I'll say it again, there will be no real winners in the situation which is now developing, only successful survivors.



NEXT MAILING: February 13th